

Health System Transactions: The Deal with Deals

Health Law Webinar

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Fredrikson

Where Law and Business Meet[®]

Overview

- Health System Financial and Legal Considerations
- Mergers & Acquisitions
- New Affiliation and Joint Venture Models
- Partnerships with Private Equity, Venture Capital and other Corporate Investors
- Investments in Start-Ups and Innovative Business Models

Financial Market Conditions and Considerations

- Intense pressure on staff and resources
- Rising expenses for supplies, drugs, equipment and workforce
- Weaker profitability and liquidity
- Shifts in where patients seek treatment
- Non-traditional financing options and partnerships

Legal Considerations

- Tax Exemption
- Fraud and Abuse
- Antitrust

Tax-Exemption Issues

- Tax-exempt health systems (and other tax-exempt entities) must comply with a host of restrictions and obligations from the IRS and state authorities
- Exempt entities must be organized and operated exclusively for a charitable purpose, demonstrate that they benefit the community, and serve a public rather than a private interest in order to maintain their tax-exempt status
- State regulators (including Attorneys General) have increasingly acquired additional oversight of exempt organizations, and transactions and arrangements in which they are involved

Tax-Exemption Issues

- Section 501(c)(3) provides tax exemption for corporations organized and operated exclusively for charitable, scientific, or educational purposes, so long as no part of the organization's net earnings inure to the benefit of any private shareholder or individual
- The promotion of health for the benefit of the community is a charitable purpose

Tax-Exemption Issues

Organizational Test:

- Exempt entity's articles of organization must:
 - Limit the purposes of such organization to one or more exempt purposes;
 - Not expressly empower the organization to engage in activities not in furtherance of one or more exempt purposes (other than as an insubstantial part of its activities);
 - Not expressly empower the organization to (a) to attempt to influence legislation by propaganda or otherwise (more than an insubstantial amount); (b) participate/intervene in a political campaign or against a candidate; or (c) be characterized as an “action” organization; and
 - Permit distribution of the organization's assets, upon dissolution, only for one or more exempt purposes or to the federal, state, or local government for a public purpose, or as may otherwise be determined by a court.

Tax-Exemption Issues

Operational Test:

- To be operated exclusively for one or more exempt purposes, the entity must meet operational test:
 - “Primary Purpose” requirement
 - Not more than “insubstantial part” of activities in furtherance of a non-exempt purpose
 - Private Inurement prohibition
 - Net earnings may not inure in whole/part to benefit of private individuals or shareholders
 - Public benefit requirements (or prohibition on excess private benefit)
 - Must serve a public interest rather than a private interest
 - Lobbying and political activity restrictions
 - No substantial activities influencing legislation; no participation in political campaigns for/against a candidate

Tax-Exemption Issues

Prohibitions Against Private Benefit and Private Inurement:

- Private benefit relates to insiders and everyone else
- Private inurement is a subset of private benefit, and relates to “insiders”
 - May include physicians, others with control
- Incidental amounts of private benefit will not jeopardize tax-exempt status
- Any amount of private inurement may jeopardize tax-exempt status
- May also result in sanctions

Tax-Exemption Issues

Application to Deals:

- Transactions must be at fair market value, including
 - Contributed assets
 - Contributed existing business
- Valuation
- Not less than fair market value to exempt entity for tax compliance
- Not more than fair market value to potential referral source

Tax-Exemption Issues

Application to Deals (continued):

- Exempt organizations must have formal or informal control over a joint venture sufficient to ensure furtherance of charitable purposes.
 - See guidelines in Redlands, St. David's, Rev. Rul. 98-15, Rev. Rule 2004-51, etc.
- Allowing too much control over an exempt organization or its activities can result in private benefit.
- Allowing an entity or person to share the profits earned from activity or investment of an exempt entity can result in private inurement.

Tax-Exemption Issues

Failure to comply with requirements can result in:

- Unrelated Business Entity Tax
- Sanctions
- Loss of Exemption
- State regulator issues, intervention
- Reputational issues
- Issues with funders

Antikickback

- It is illegal to offer, solicit, make or receive any payment intended to influence referrals under a federal health care program
- The government applies the “one purpose” test:
 - If one purpose of the payment is to influence referrals, the payment is illegal
- “Sale of Practice” Safe Harbor
- Not required to meet a safe harbor
- Similar state laws may apply
- Impact on earnouts / post-closing consideration

Stark

- Prohibits a physician from making a referral to a provider for “designated health services” if the physician has a financial relationship with the provider, unless an exception applies:
 - Isolated Transaction Exception
 - Fair Market Value
- Examples: imaging, lab services, PT/OT/SLP
- Intent doesn’t matter; strict liability statute
- Consider state self-referral laws
- Impact on earnouts / post-closing consideration

Antitrust

- Sherman Act
- Clayton Act
- Federal Trade Commission Act
- State Antitrust Laws

Sherman Act, Section 1

- Section 1 prohibits contracts, combinations or conspiracies in restraint of trade
 - Per se violations: price-fixing, allocation of territories or customers, customer or other nonprice restraints, group boycotts and concerted refusals to deal, tying agreements and exclusive dealing arrangements
 - Rule of Reason
 - Does the challenged agreement promote or suppress competition?
 - Does the challenged agreement unreasonably restrain trade?

Sherman Act, Section 1

- Section 1 violation requires
 - Agreement between two or more economic entities which has an anticompetitive purpose
 - Parent/subsidiary relationships?
 - Joint ventures?

Antitrust

- Can a member conspire with the joint venture in violation of the Sherman Act?
 - Examples: payor contracting, territory allocation, etc.
 - *Copperweld Corp. vs. Independent Tube Corp.* (U.S. 1984)
 - Involved a parent and wholly-owned subsidiary
 - One entity for antitrust purposes if
 - Unity of economic interest
 - Common, not disparate objectives
 - Corporate actions guided by a single “corporate consciousness”

Antitrust

- If *Copperweld* satisfied, arrangement analyzed under Section 2 of the Sherman Act
 - Prohibits conduct that creates, sustains, or threatens monopolization
 - More difficult to prove than Section 1 violations
 - *Copperweld* requirements not clear
 - “Legal control” test
 - Could parent exert full control over subsidiary (JV) if failed to act in parent’s best interest
 - “Unity of interest” demonstrated by preponderance of multiple factors

Antitrust

- Application to Deals

- Hart-Scott-Rodino (HSR) filings
- Due diligence
 - Timing
 - Competitively sensitive information (“CSI”)
 - Consider using a third party to analyze CSI
- Gun Jumping
- Execution
- *Copperweld* issues

Mergers & Acquisitions – Process

- Letter of Intent / Term Sheet
 - Typically non-binding, but may have some binding terms
 - Exclusivity, cooperation with diligence, confidentiality
- Due diligence
 - Assemble team
- Negotiate and execute legal agreements
- Satisfy closing conditions and obtain approvals
 - Dealing with third parties (e.g., landlords, licensing authorities)
- Closing of transaction

Change of Ownership Process

- Medicare
- Medicaid
- State licensing
- Certificate of Need

Health Information

- HIPAA
 - PHI may be disclosed in a “sale, transfer, merger, or consolidation of all or part of the covered entity with another covered entity, or an entity that following such activity will become a covered entity and due diligence related to such activity.”
- 42 CFR Part 2
- State Law

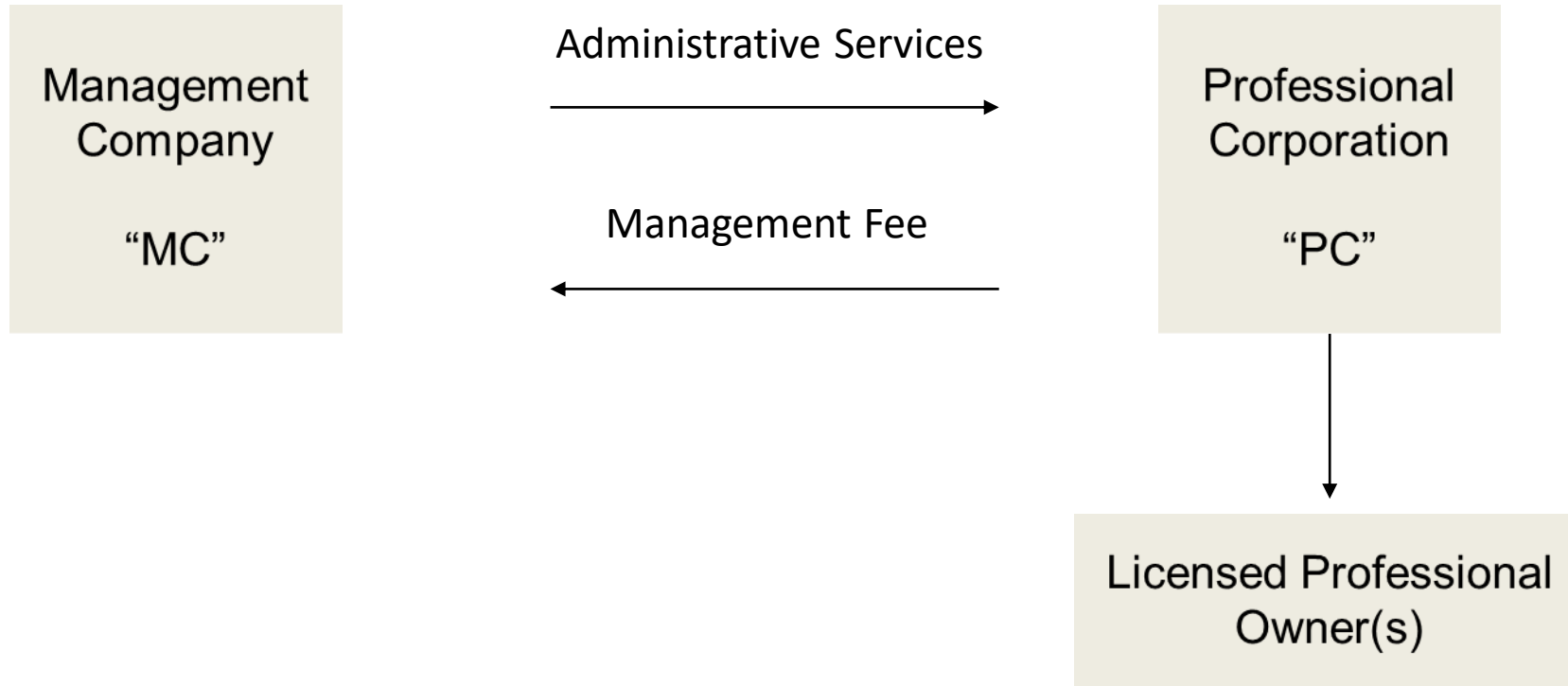
Health Information

- HIPAA Policies and Procedures
- Employee Training
- Security Risk Assessment
- Breaches
- Business Associate Agreements

Corporate Practice of Medicine (“CPOM”) Prohibition

- Prohibits corporations from employing professional or owning professional practices
- Applies to many disciplines (e.g., dentistry, nursing)
- Potential Ramifications for Violating CPOM Prohibition
 - Injunction against continued operation of practice
 - Criminal prosecution for engaging in the unauthorized practice of medicine
 - Entire arrangement could be declared void
 - Refusal to pay claims
 - Loss of “private practice”, “physician office” and similar exceptions from state licensing requirements (CON, lab license, etc.)

Friendly PC Arrangement



Friendly PC Arrangement

- Common Aspects of Management Agreement
 - Long-term
 - Restrictions on termination
 - Restrictive covenant
 - Management fee
- Other Agreements re: Continuity of Ownership

Employment

- Physicians/providers are typically a key attraction:
 - Do they fit the Buyer's criteria for employment (e.g., credentialing and privileges)?
 - What if one or more do not want to sell?
 - Key terms include term and termination events, compensation, duties, locations, hours, benefits, time-off
 - Other key terms include change of control provisions (i.e., Buyer's ability to assign to a new buyer without consent), governance, covenant not to compete
- Support Staff

Restrictive Covenants

- Will the Buyer require a covenant not to compete?
- Geographic and temporal scope
- Important to consider if certain events should cause covenant not to compete to become unenforceable (e.g., Buyer decides to sell/merge with another organization)
- Seller rights in the event of a breach
- Enforceability
 - State law
 - FTC

Innovative Affiliation and Joint Venture Models

Value-Based Care Arrangements

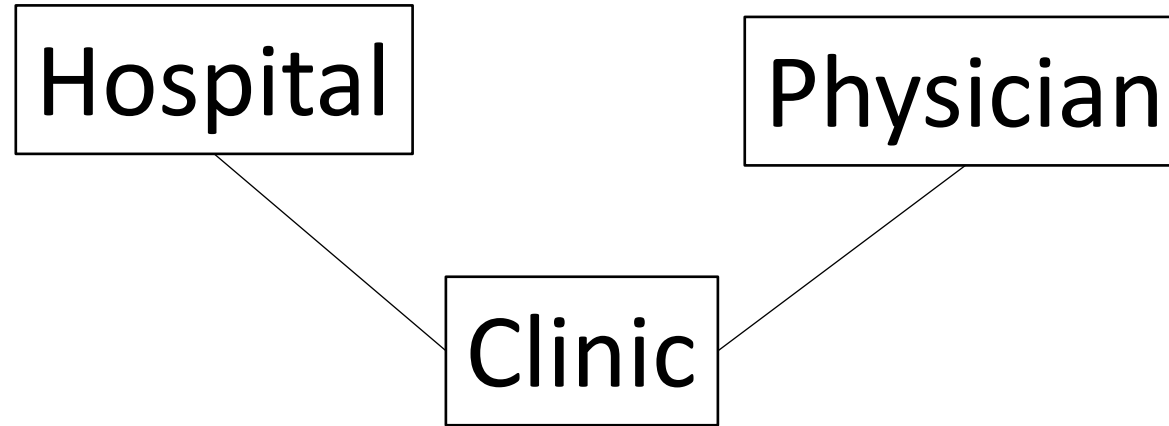
- Broad umbrella of arrangements
- Shift from fee-for-service payment toward quality and cost accountability
- Regulatory Amendments
 - Stark
 - Antikickback

VBE – In Practice

- VBEs do not need to be separate legal entities
- VBEs may take the form of a CIN (or other physician network), ACO, or separately established legal entity to manage and administer value-based care arrangements
- Tied to specific and identified “target patient populations”

Hospital Investment in Clinics

Hospital Investment in Clinic



Stark Law

- The prohibition on referrals set forth in § 411.353 does not apply to the following types of services:
 - (b) In-office ancillary services

Stark Law

- (3) They are billed by one of the following:
 - (i) The physician performing or supervising the service.
 - (ii) The group practice of which the performing or supervising physician is a member under a billing number assigned to the group practice.
 - (iii) The group practice if the supervising physician is a “physician in the group practice” (as defined at § 411.351) under a billing number assigned to the group practice.

Group Practice

- Single legal entity. For purposes of this subpart, a group practice is a physician practice that meets the following conditions:
 - The group practice must consist of a single legal entity operating primarily for the purpose of being a physician group practice in any organizational form recognized by the state in which the group practice achieves its legal status, including, but not limited to, a partnership, professional corporation, limited liability company, foundation, nonprofit corporation, faculty practice plan, or similar association. The single legal entity may be organized by any party or parties, including, but not limited to, physicians, health care facilities, or other persons or entities (including, but not limited to, physicians individually incorporated as professional corporations...

What About Antikickback?

- Likely will not meet small entity safe harbor
- Meet as many requirements as possible—no sweetheart deal
- Intent key to analysis

Corporate Practice Doctrine

- State laws differ
- Hospital authority
- No lay governance
- Associated PC
- Nonprofit exception

Class B Shares

- Rights and preferences set forth in resolution
- Profit and loss in JV operations
- Preferred? Convertible? Withdrawal?
- Governance
- Divisional Structure?

Examples

- Hospital wants to work with clinic to establish a new clinic location
- Hospital wants to bring clinic into system, but clinic wants to retain independence

Lessons Learned

- Investment in clinic is an underused strategy
- Many forms and approaches
- Don't do this at home

Technical Service Ventures

- Hospital can generally participate in unlicensed activities

ASC Joint Ventures

- Substantial hospital investments in ASCs
 - What are the critical terms?
 - Which laws are relevant?
 - Many creative ASC JVs being developed across the country.

Hospital Payer Co-ownership



Payer Responsibility for Provider's Economic Results

- Most alignment arrangements don't do this
- Payer ownership of part or all of provider
- Contract that approximates financial results of ownership

Ownership Issues

- Exemption—*Redlands* analysis
- Corporate Practice
- Conflict of Interest
- Choice of Entity
- Governance—preserving separate interests

Options, Covenants and Other Rights

- Option to Buy
- Right of First Refusal
- Covenant to Not Sell
- Other Agreements...

Investments in Start-Ups and Innovative Business Models

- Variety of approaches to investing in innovation
- Financing
 - System-sponsored venture funds
- Technology Transfer
- Data
- Beta-Testing
- Partnering with VC/PE

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Health systems are increasingly looking to expand and strengthen their services and resources through partnerships with PE, VC and other for-profit investors (“PE investors”)
- PE investors are increasingly looking for opportunities with health systems to commercialize successful and/or promising products and services of those systems

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- PE investors offer:
 - Readily available capital investments
 - Access to innovation
 - Speed to market in capabilities and culture
 - Business and commercialization capabilities
 - Access to resources
 - Expertise
 - Economies of scale

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Health systems offer:
 - Reputation and credibility (for investors and consumers)
 - Systems and operations
 - Resources
 - Expertise
 - Experience
 - Brand
 - Stability

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- PE investors' focus:
 - Maximize financial return on investment
 - Short-term investment horizon
 - Consolidation
 - Agility, urgency
 - Investor driven
 - Higher risk tolerance

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Health systems' values:
 - Charitable purpose
 - Mission driven
 - Patient care and positive outcomes
 - Long-term relationships with providers and community
 - Limited downside financial risk
 - Due attention to regulatory compliance

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- The mission and culture of a health system and the goals and culture of PE investor may diverge or even clash, especially around:
 - Divergent regulatory considerations and experiences
 - Dissimilar governance structure and timeline expectations
 - Different financial focus and priorities
 - Competing priorities of backing investors and system governance
 - Different priorities regarding selection of providers, service operations
 - Different levels of risk tolerance

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- To meet its objectives the PE investor will typically seek:
 - Sufficient control to consolidate financials
 - Freedom to exit the arrangement, add investors
 - Access to key health system resources, including payor arrangements, operational systems, IP
 - Streamlined decision making processes
 - Aggressive timelines

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Due to legal requirements, mission, and best practices, the tax-exempt entity will typically:
 - Place great emphasis on the fair market value of all financial relationships and require valuation(s)
 - Require the joint venture to act in accordance with the exempt entity's charitable purpose
 - Require sufficient control by the exempt entity to allow it to ensure furtherance of its charitable purpose

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Additional safeguards the tax-exempt entity will typically require:
 - Broad protection of the exempt entity's tax-exempt status, including termination rights if status is jeopardized
 - Rights or guardrails related to PE investor's exit and its assignment to successors, and investment by new partners
 - Obligations related to compliance with applicable bond requirements for property financed with tax-exempt bonds (e.g., private use issues)

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Understanding and addressing upfront the potential conflict of PE investor goals and health system values going in, and a mutual commitment to work together on creative and compliant solutions, is key to proceeding successfully.
- Using experienced health care counsel for both parties makes the process much more efficient.
- Parties should work together early to adequately address gating issues (e.g., requirements around tax-exemption, control, governance, exempt purpose), before investing significant resources.

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Mechanisms for control and other protections for exempt organizations include one or more of the following:
 - Holding a voting majority of the board
 - Majority ownership and associated voting rights
 - Reserved powers and/or initiation rights over key issues (charitable purpose, mission, strategy, services, charity care, Medicare and Medicaid participation, affiliations, compensation, appointment/removal of CEO, sale, dissolution, admission of new members, capital contributions, etc.)
 - Supermajority vote requirements for key issues

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Mechanisms for control and other protections for exempt organizations include one or more of the following (cont.):
 - Contractual requirements to serve the charitable purpose of the exempt entity, and for the benefit of the community, over maximization of profits
 - Ensure management contracts meet private use requirements
 - Prohibition on specific acts that could jeopardize exemption
 - Contractually declare acts or omissions that would jeopardize tax-exempt status to be void

Partnerships with Private Equity, Venture Capital and Other Corporate Investors

- Don't forget the other key regulatory issues when partnering with PE investors:
 - Corporate Practice of Medicine
 - Licensed health system entity likely has exceptions not available to unlicensed business entity
 - Fraud and Abuse Laws
 - Anti-Kickback laws, Stark law, fee-splitting prohibitions and other federal and state laws
 - Medicare, Medicaid and other payer rules and regulations
 - Antitrust Law

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Thank you!

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